

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR: [REDACTED]:TL-N-POSTF-145498-01
[REDACTED]

date: August 21, 2002

to:

[REDACTED]
LMSB Group [REDACTED], [REDACTED]

from:

[REDACTED]
Special Litigation Assistant
[REDACTED]

Subject: Request for Assistance: [REDACTED], Inc.

This supplements our memorandum dated August 2, 2002, regarding [REDACTED]. As we mentioned, the memorandum was subject to post-review by the National Office. This review has been completed and has not resulted in any modification of the conclusions expressed in the memorandum.

The National Office wishes us to add that the memorandum is not intended to address all possible areas of controversy between the Service and the taxpayer with respect to the taxpayer's claimed R&D credits, and that no inference should be drawn from the omission of other issues from the memorandum. We noted at page five of the memorandum that the audit team is considering other serious issues with respect to [REDACTED]'s R&D claim, such as whether the R&D activities are duplications, adaptations, or mere surveys and whether they qualify under the "process of experimentation" requirement of I.R.C. § 174. We encourage the audit team to develop and consider all such issues, and not rely solely on the issues addressed in the memorandum as the basis for allowance or disallowance of the R&D under consideration.

Also please note that several words were inadvertently omitted from the last sentence in the fourth paragraph on page 21. The sentence should have read:

The taxpayer pointed to the contract terms that provided that progress payments could not be retained unless the work for which those progress payments were made was delivered and accepted by the Air Force.

The underlined words were omitted from the text.

If you have any questions about this or need any other assistance in this matter, please feel free to contact the undersigned at [REDACTED], (b)(7)c.

[REDACTED]
[REDACTED]
[REDACTED] Special Litigation Assistant

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:[REDACTED]:POSTF-145498-01
[REDACTED]

date: August 2, 2002

to: [REDACTED], Team Manager
LMSB Group [REDACTED], [REDACTED]

from: [REDACTED]
Special Litigation Assistant
([REDACTED])

subject: Request for Assistance
[REDACTED]
[REDACTED]

By memorandum dated August 23, 2001, our assistance was requested in regard to certain issues concerning the taxpayer's entitlement to I.R.C. § 41 research credits. Particularly, we were asked whether the taxpayer's contracts pursuant to which it provides various engineering and architectural services are "funded" or "unfunded" within the meaning of I.R.C. § 41.

It became apparent that we would have to select a small number of contracts upon which to focus a response. Somewhat lengthy discussions were held with the taxpayer to select a group of representative contracts. Ultimately, a group of ten contracts was selected, which are the contracts discussed in this memorandum. There is no agreement, however, to apply the results in these ten contracts to all of taxpayer's thousands of contracts.

In addition, we requested additional information and documents regarding the contracts in the selected group from the examination team. These requests often needed to be obtained from the taxpayer, an often lengthy process. Additionally, at various points, [REDACTED] requested an opportunity to present written position papers on various points and questions raised as this memorandum was written. This, too, contributed to some delay. Finally, as a result of the information and discussions, the scope of this memorandum was expanded to include additional issues.

This memorandum has been discussed with [REDACTED], Senior Legal Counsel, and with [REDACTED], R&D Lead Counsel. Industry Counsel, in particular, has had substantial input into

this memorandum and suggested the inclusion of Issue 3 (business component). The matter is assigned in this office to SLA [REDACTED]. His telephone number is (b)(7)c [REDACTED].

THIS DOCUMENT IS SUBJECT TO POST REVIEW BY THE NATIONAL OFFICE. SIMULTANEOUSLY WITH THE ISSUANCE OF THIS ADVICE TO YOU, WE WILL BE SENDING IT TO THE NATIONAL OFFICE FOR A TEN-DAY REVIEW UNDER THE NON-DOCKETED SIGNIFICANT ADVICE PROGRAM. PLEASE WAIT UNTIL THIS REVIEW IS COMPLETED BEFORE ACTING ON THIS ADVICE.

THIS DOCUMENT MAY CONTAIN PRIVILEGED OR OTHER CONFIDENTIAL INFORMATION. ANY UNAUTHORIZED DISCLOSURE MAY WAIVE SUCH PRIVILEGE OR OTHERWISE ADVERSELY AFFECT CONFIDENTIALITY. IF DISCLOSURE IS BEING CONSIDERED, PLEASE CONTACT US FOR OUR VIEWS PRIOR TO ANY DISCLOSURE.

ISSUES

1. Whether [REDACTED] incurred costs under contracts for architectural, engineering, construction management, and other consulting services that are contingent on success and therefore not "funded" within the meaning of Treas. Reg. § 1.41-5(d)(1).
2. Whether [REDACTED] incurred costs under contracts that retained "substantial rights" so that the requirements of Treas. Reg. § 1.41-5(d)(1)(D)(4)(H) for a "funded" contract are met in regard to these contracts.
3. Whether [REDACTED] incurred costs under contracts that were undertaken in regard to the development or improvement of a "business component", as that term is defined in I.R.C. § 41(d)(2)(B), and that are incident to the development or improvement of a product, as that term is defined in Treas. Reg. § 1.174-2(a)(2).

PROPOSED CONCLUSIONS

1. Except for the contracts with [REDACTED] and [REDACTED], [REDACTED] incurred costs under contracts that are not contingent on success, so that they are "funded" within the meaning of Treas. Reg. § 1.41-5(d)(1).
2. Except for the [REDACTED] contract, [REDACTED] incurred costs under contracts in which it retained substantial rights to use the research within the meaning of Treas. Reg. § 1.41-5(d)(2).
3. With respect to all the contracts discussed in this memorandum except for the [REDACTED] and [REDACTED] contracts, [REDACTED]'s costs were not incurred in regard to a "business component," as that

term is used in I.R.C. § 41(d)(2)(B), and are not incident to the development of a product, as that term is defined in Treas. Reg. §1.174-2(a)(2).

FACTS

I. Taxpayer Background

[REDACTED]

[REDACTED]

II. R&D Credit Claimed

On its original [REDACTED] and [REDACTED] returns, [REDACTED] claimed approximately \$[REDACTED] and \$[REDACTED] in R&D credits, respectively. In [REDACTED], [REDACTED] commissioned [REDACTED] to perform an R&D study. The results were as follows:

Year	Claim	Year	Claim
[REDACTED]	\$ [REDACTED]	[REDACTED]	\$ [REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

		Total	\$
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The study primarily involved internal use software. One engineering design project was included. These amounts were included on amended or filed returns.

In , commissioned ("") to perform a study of R&D. This study resulted in the following amounts of additional research credit claimed:

	\$		\$
		Total	\$

has filed claims for refund for and , and has included the above amounts in its filed returns for and . It is assumed that there probably remain carryover research credits in years after .

III. The Study

The scope of the R&D study included the consolidated subsidiaries of , Inc. and (""). The study included statistical sampling of all projects (except projects from through , which were unavailable). The population of projects was over

█. Approximately █ projects per year were selected randomly. █ then interviewed each project manager of the first seven yearly projects for which the original project manager was still a █ employee. The interview was based on the tests for qualification for the research credit contained in the Regulations. The project manager would determine the percentage of each employee's time spent on qualified research. This percentage was indicated on a form developed by █ called the "signature sheet" because it was then signed by the interviewee.

The percentage determined was then used to determine a qualified research expenditure percentage (QRE%) for each project. Funding was also considered by █. If the project was determined to be unfunded, and the project had qualified costs (based on the interview), its QRE% was averaged with the other six projects to arrive at a QRE% for the year. The annual QRE% was then multiplied by the total labor costs (per project reports) and "direct" supply costs (per the G/L) to arrive at total qualified research costs for the year.

IV. Examination Background

Currently, the Service is examining the █ 1120 and 1120X's containing the █ research credit claims. The agents have obtained copies of the contracts from the projects selected for the interviews, some internal project descriptions and progress reports, and a few interview sheets signed by the project managers. The examination team has obtained a small number of the handwritten notes and project files from █'s study. The agents are continuing to consider other issues in regard to whether the research and costs are qualifying research costs, the statistical sampling methodology used in the █ survey, and various other computational and technical issues relating to the credit, in addition to issues described above.

V. Terminology

In the years covered by this memorandum, the █ group consisted of █, Inc. and a number of subsidiaries. As a result of consolidation, a number of the subsidiaries were merged into █, Inc. While some contracts are in the name of █, Inc., a number of contracts are in the names of other subsidiaries. For convenience, we will refer to the consolidated group as █. We will use this same term as the party to various contracts, although individual contracts were in the name of █, Inc. or another subsidiary. The party with whom █ contracted will be referred to as the owner or client.

Providers of services such as architects and engineers will be referred to as design professionals. Their services will be referred to as design work or consulting services. The work product of design professionals, such as blue prints, plans, specifications, drawings, reports, and schematics will sometimes be referred to as design and consulting product.

VI. The Contracts

A. Selection

Ten contracts were selected for inclusion in this request after consultation with the taxpayer and the examination team. These contracts are from the projects selected in the [REDACTED] statistical study. They contain terms and features common to many of the taxpayer's contracts. The common types of contracts used by the taxpayer are (1) fixed price, (2) time and material with a cap, and (3) time and material with no cap. They may also be divided into design-only and design and build contracts. While falling into these general categories, [REDACTED]'s contracts are individually negotiated and drafted. A number of the selected contracts are in the form of a master contract supplemented by authorizations for expenditure, generally called a task order. In such cases, selected authorizations are discussed. Project numbers used here are the number given by [REDACTED] for identification and accounting purposes.

Although [REDACTED] agrees that the contracts discussed here represent a "cross section" of the contracts used by the taxpayer in its business, it has not agreed to apply determinations made with respect to these contracts to all of the taxpayer's contracts. The examination team expected, however, that the principles derived with respect to the selected contracts will be applied to all of [REDACTED]'s contracts.

The discussion of the ten selected contracts contains a summary of significant, but not all, contract terms. It is intended to give the reader the highlights of the contract. The reader should refer to the contracts themselves for a complete understanding of the terms and conditions in the contracts.

B. Contracts

1. [REDACTED] (" [REDACTED] "), Project # [REDACTED]

This [REDACTED] contract involves design work and construction assistance relating to an addition to [REDACTED]'s [REDACTED]

[REDACTED]. Payment is based on specified hourly rates with a fixed "not to exceed" amount. Under the statistical methodology of the [REDACTED] study, this project was selected twice out of the [REDACTED] selected from the taxpayer's statistical sample for that year; thus, it is heavily weighted in the [REDACTED] study. The taxpayer has claimed labor costs incurred during [REDACTED], as qualified research expenditures for purposes of computing its research credit ([REDACTED]% of the labor incurred for this project in [REDACTED] was considered QRE's).

Compensation is based on hourly rates set forth in Exhibit to the contract with "not to exceed" limits. Specific compensation details are to be set forth in letters of authorization. [REDACTED] Contract § [REDACTED]. Invoicing for payment is monthly. Payment is required within [REDACTED] days of invoice. [REDACTED] Contract § [REDACTED].

Article [REDACTED] of the [REDACTED] Contract governs performance by the taxpayer. Section [REDACTED] states that the taxpayer shall perform "[REDACTED]
[REDACTED]."

Section [REDACTED] provides for indemnification by [REDACTED] for all claims, damages, losses, demands, judgments, costs of suit, defense experts, and attorney's fees, arising out of or resulting from negligent performance by the taxpayer. [REDACTED] agrees to indemnify taxpayer for all toxic damages, except those resulting from the taxpayer's negligence. [REDACTED] Contract § [REDACTED]. [REDACTED] must furnish Error & Omission Insurance to cover \$[REDACTED] for each claim. [REDACTED] Contract § [REDACTED]

Article [REDACTED] covers [REDACTED]'s liability for correction of errors or additional work. Under this provision, [REDACTED] bears the cost of additional design and work if omitted and discovered by the taxpayer. The taxpayer bears the cost of additional expense due to work being more difficult or to correct any of the taxpayer's errors. [REDACTED] Contract § [REDACTED].

All drawings and specifications remain the property of the [REDACTED]. [REDACTED] is prohibited from using drawings and specifications in any other project without the consent of the taxpayer, which consent will not be unreasonably withheld. [REDACTED] Contract \$ [REDACTED].

Either party may terminate the contract with or without cause. If terminated, the taxpayer is entitled to compensation for services rendered through the date of termination. Contract § [REDACTED].

The contract contains a choice of law provision. The parties agree that the contract is to be interpreted pursuant to the laws of [REDACTED].

2. [REDACTED] (" [REDACTED]"), Project # [REDACTED]

[REDACTED] is a [REDACTED] manufacturer of [REDACTED] used in the [REDACTED] industry, such as [REDACTED], [REDACTED], and [REDACTED]. Taxpayer's subsidiary, [REDACTED], was engaged to design what was to be the first [REDACTED] facility outside [REDACTED].

The fixed-price project involved transference of [REDACTED]'s technology and know-how from [REDACTED] to the United States while meeting U.S. health, environmental and safety standards. A secondary but challenging constraint was obtaining materials and manufacturers to meet [REDACTED]'s rigorous quality standards in the United States. The plant was to have a high-tech lab in which client's products could be tested. According to the taxpayer, [REDACTED] had not worked with the level of technology in this facility.

This project was one of the [REDACTED] analyzed for [REDACTED] in [REDACTED] as part of the taxpayer's statistical sample for that year. The taxpayer has claimed labor costs incurred during [REDACTED], as qualified research expenditures for purposes of computing its research credit ([REDACTED]% of the labor incurred for this project in [REDACTED] was considered QRE's).

The [REDACTED] contract calls for [REDACTED] to furnish the architectural, engineering, equipment procurement and installation and construction services as set forth therein. [REDACTED] agrees to furnish business administration and superintendence, and to use its best efforts to complete the Project in the most expeditious and economical manner consistent with the standard of care of a reasonable and prudent Design/Builder in [REDACTED] and the interests of the Owner. The work comprises the design and construction of the Project and includes labor necessary to produce such construction, and materials and equipment incorporated or to be incorporated in such construction.

The contract specifies a maximum price of \$ [REDACTED]. Contract \$ [REDACTED]. This maximum price includes a fee of \$ [REDACTED] representing [REDACTED]% of direct construction costs. [REDACTED] Contract \$ [REDACTED]. This fee could be adjusted to take into account approved changes and delays. [REDACTED] Contract \$ [REDACTED]. This fee included profit, general operating expenses, a portion of taxpayer's cost of capital, and overhead. [REDACTED] Contract \$ [REDACTED]. Project costs were defined in [REDACTED] Contract Art. [REDACTED].

Payments are in the form of progress payments approved by a "site committee" of authorized representatives of [REDACTED] and [REDACTED]. Payments approved by the site committee include estimated expenses and a percentage of completed work. No progress payment or partial use or occupancy constituted acceptance of work not in accordance with the contract. [REDACTED] Contract § [REDACTED].

Final payment is due [REDACTED] days after occupancy or a certificate of occupancy has been issued. Final payment constitutes a waiver by [REDACTED] of all unsettled liens, faulty or defective work, failure of work to comply with the contract, and terms of special warranties required by the contract. [REDACTED] Contract § [REDACTED]. Acceptance also constituted a waiver of all known claims by [REDACTED] except those previously made in writing and identified as unsettled at the time of final payment. [REDACTED] Contract § [REDACTED].

Article [REDACTED] covers the ownership of plans and drawings.

" [REDACTED] . "

Article [REDACTED] covers the services and duties to be provided under the contract. Article [REDACTED] states that the work will be performed by qualified architects, engineers and other professionals. Qualified contractors and suppliers will perform construction.

Article [REDACTED] provides that [REDACTED] shall submit required Construction Documents including technical drawings, diagrams, schedules, and documents for regulatory approvals to [REDACTED] for approval. Such documents will develop [REDACTED]'s intent in greater detail, provide the information customarily needed by other construction trades, and include documents customarily required for regulatory approvals. In addition, [REDACTED] agreed to coordinate construction activity, submit a detailed progress schedule, keep full and detailed accounts, provide builder's risk insurance, and correct nonconforming work, and other miscellaneous acts and duties. [REDACTED] Contract [REDACTED]. Under section [REDACTED] of the contract, [REDACTED] warranted to [REDACTED] that the work under the contract

would be "[REDACTED]"

Article [REDACTED] of the [REDACTED] contract requires various forms of insurance coverage, including comprehensive, workers compensation, and automobile liability. It also requires professional liability insurance with coverage in the aggregate amount of \$[REDACTED] to remain in force for [REDACTED] years after completion. Such insurance in no way limits [REDACTED]'s ultimate liability. In addition, [REDACTED] is required to obtain Builder's Risk insurance for the full cost of replacement of the project to insure against fire, flood, earthquake, vandalism, and damage from defective workmanship, design or material.

Article [REDACTED] deals with correction of work rejected by [REDACTED] due to defective work or materials. Such correction was required within one year of completion. If not corrected, [REDACTED] was empowered to undertake the correction, and deduct the amount paid from amounts owed to the taxpayer.

Article [REDACTED] states that the client may terminate with cause, but must pay [REDACTED] the lump sum less costs to make good any deficiency. The client may terminate without cause, but must pay [REDACTED] any due costs. [REDACTED] law governs the contract. [REDACTED] Contract Art. [REDACTED].

3. [REDACTED], ("[REDACTED]"), Project # [REDACTED]

[REDACTED] was the subcontractor under a prime contract held by [REDACTED]. The [REDACTED] prime contract was with [REDACTED] ([REDACTED]), and was for the development, preliminary design, and final design of a [REDACTED]. The subcontract, dated [REDACTED], states that subconsultant ([REDACTED]) shall provide all professional services as noted in Exhibit [REDACTED] - scope of work.

This project was one of the [REDACTED] analyzed for [REDACTED] in [REDACTED], as part of the taxpayer's statistical sample for that year. The taxpayer has claimed labor costs incurred during [REDACTED], as qualified research expenditures for purposes of computing its research credit ([REDACTED]% of the labor incurred for this project in [REDACTED] was considered QRE's).

The subcontract provides for payment of \$[REDACTED] on satisfactory completion of all services. Terms and conditions of the [REDACTED] prime contract are incorporated by reference.

Section [REDACTED] of the prime contract provides that all reports, studies, etc. are subject to the private use, copyright or patent by the taxpayer without the Owner's consent. Any reuse by the Owner is at the owner's sole risk. The agreement was terminable by the Owner on seven days notice.

4. [REDACTED] (" [REDACTED] "), Project No. [REDACTED]

This agreement, effective [REDACTED], was a Blanket Agreement Covering Professional Services Work to be performed for [REDACTED] over a [REDACTED]-year period. Article [REDACTED] defines the term work to mean any and all work, labor and/or services of any type, nature or description whatsoever performed by [REDACTED], including engineering services, surveying services, monitoring services, testing services, studies, or any other services.

Section [REDACTED] of the [REDACTED] contract provides that the standard of care applicable to [REDACTED] is the degree of skill and diligence normally employed by professional engineers or consultants performing the same or similar work. [REDACTED] must re-perform any services not meeting this standard without additional cost to [REDACTED].

Section [REDACTED] permits termination by [REDACTED] at will, in which case [REDACTED] will pay for services up to the date of termination.

This project was one of the seven analyzed for [REDACTED] in [REDACTED], as part of the taxpayer's statistical sample for that year. The taxpayer has claimed labor costs incurred during [REDACTED], as qualified research expenditures for purposes of computing its research credit ([REDACTED]% of the labor incurred for this project in [REDACTED] was considered QRE's).

The parties designated [REDACTED] law as controlling.

5. [REDACTED] (" [REDACTED] "),
Project # [REDACTED]

[REDACTED] is the operator of a [REDACTED]. At some point in time, a [REDACTED] that began under the [REDACTED] spread to adjacent property and into a stream or river. [REDACTED] and the [REDACTED] (" [REDACTED] "), a state agency, entered into an agreement that required the monitoring of existing recovery systems and the surrounding area. In [REDACTED], monitoring devices detected seepage of [REDACTED] into the stream beyond the existing containment system. [REDACTED] was engaged to provide miscellaneous engineering services as set forth in Attachment [REDACTED] - Scope of Services regarding monitoring and remediation work and to provide support to [REDACTED]'s law firm ([REDACTED]).

This project was one of the [REDACTED] analyzed for [REDACTED] in [REDACTED], as part of the taxpayer's statistical sample for that year. The taxpayer has claimed labor costs incurred during [REDACTED], as qualified research expenditures for purposes of computing its research credit ([REDACTED]% of the labor incurred for this project in [REDACTED] was considered QRE's). These labor costs were incurred under Task Order No. [REDACTED], dated [REDACTED].

The [REDACTED] contract is on the taxpayer's "Standard Agreement For Professional Services" form, and is described as miscellaneous professional regulatory compliance review, investigation planning and site investigation for the [REDACTED]. Work to be performed and compensation are to be set forth in task orders. Compensation will be made in accordance with the hourly billing rates shown in Attachment [REDACTED].

Attachment [REDACTED], Scope of Services, states that this is a general Scope of Services for on-call professional [REDACTED] services for tasks identified by Client at the [REDACTED]. It further states that miscellaneous services that may be ordered include assistance with regulatory compliance and negotiations with [REDACTED], field investigation planning and oversight, and subcontracted field investigation services.

Section [REDACTED] sets forth the standard of care to be used by the taxpayer. It is the degree of diligence and skill normally employed by professional engineers or consultants performing the same or similar services at the time. The section further provides that the taxpayer will redo any services not meeting this standard at its own expense.

The taxpayer is required to have errors and omission insurance to cover liability of \$ [REDACTED] per occurrence. Liability to [REDACTED] is capped at \$ [REDACTED]. [REDACTED] Contract \$ [REDACTED]. It is also not liable for consequential damages. Id. \$ [REDACTED].

Article [REDACTED] contains several provisions relating to termination. Termination for "convenience" is permitted on [REDACTED] hours' notice. Termination for cause is permitted if either party fails to perform. [REDACTED] Contract \$ [REDACTED]. The taxpayer will be paid for all services performed up to the time of termination, plus termination expenses, such as reassignment of personal, subcontract termination, and related "closeout" costs. [REDACTED] Contract \$ [REDACTED].

Section [REDACTED] provides that all reports, drawings etc., are "[REDACTED]." [REDACTED] agrees to indemnify taxpayer for any unauthorized use.

Section [REDACTED] provides that the law of the project state shall govern the agreement. The project was located in [REDACTED].

Task Order No. [REDACTED], dated [REDACTED], specifies that the taxpayer is to submit a revised draft investigation plan for the offsite [REDACTED]. This order further provides that assistance in negotiations with the [REDACTED] shall be provided as requested. The Task Order states that it is a "[REDACTED]" order. Total payment for this task order is not to exceed \$ [REDACTED]. The deliverable for this task order is a revised draft investigation plan, which shall be submitted on or before [REDACTED]. The period of performance for this task order is [REDACTED] - [REDACTED].

Task Order No. [REDACTED], dated [REDACTED], specifies that the taxpayer is to prepare a [REDACTED] for the adjacent property and provide [REDACTED] employees as expert witnesses. The Task Order states that it is a "[REDACTED]" order. Payment is not to exceed \$ [REDACTED]. The deliverables for this task order are a draft remediation plan and a final remediation plan. The period of performance for this task order is [REDACTED] - [REDACTED].

6. [REDACTED] (" [REDACTED]"),
Project # [REDACTED]

This contract is a master agreement calling for [REDACTED] services for a [REDACTED]-year period relating to studies and design work regarding the sewage treatment system operated by [REDACTED].

The master agreement was amended several times. Amendment , dated , authorized a specific project involving development of a plan for the in an amount not to exceed \$. Amendment , dated , authorized the pre-design work for \$. This amendment included a site investigation, special studies, permitting support, and predesign work. The Amendment to the master agreement, dated , was for \$, and was for the (see Exhibit to the Amendment). This amendment included site investigations, special studies, permitting support, and the final design work.

This project was one of the analyzed in , as part of the 's statistical sample for that year. The taxpayer has claimed labor costs incurred during , as qualified research expenditures for purposes of computing its research credit (% of the labor incurred for this project in was considered QRE's). These labor costs were incurred under the Amendment to the master agreement, and related to site investigations, permitting and final design of the .

The contract was terminable without cause by at any time. If terminated, the taxpayer would be reimbursed for costs directly arising out of termination and will be paid for all work prior to termination. Taxpayer had no right to terminate per the contract.

Article deals with taxpayer and 's right to use the work product of the contract. All blueprints, plans and other documents are considered "works made for hire," and are property of the , including all copyrights. Contract § . Section . provides, however, that shall obtain the taxpayer's consent before using engineering designs produced by the taxpayer for unrelated projects.

7. (" "),
Project #

This contract, dated , is a master agreement for

. No work was authorized unless requested in a Task Order, which would also set forth the compensation for that task. There was apparently one Task Order, which dealt with the

[REDACTED]. The law of [REDACTED] controls the contract.

Compensation for providing the services described in this task order was based on [REDACTED] times [REDACTED]'s salary costs. Taxpayer was to be paid [REDACTED] days from an invoice. Disputed amounts could be withheld, but undisputed amounts were to be paid.

The contract contains a standard of care provision. It states that "[REDACTED]

[REDACTED]. " [REDACTED] Art. [REDACTED]. It further states that any work done by [REDACTED] to correct any services not meeting this standard will be performed at its own cost. [REDACTED] Contract § [REDACTED].

Termination was permissible by either party with [REDACTED] days notice with or without cause. Pending obligations shall be completed and compensated. On termination, the taxpayer will be paid for all authorized work performed up to the termination date.

Task Order No. [REDACTED], dated [REDACTED], provided for the development of a "[REDACTED]" ([REDACTED]).

The purpose of this system was to provide the [REDACTED]'s management and staff with tools to better serve its customers. This system would enhance the operational efficiency and life of the [REDACTED]'s [REDACTED] by maintaining records in a central computer database, and locating major system components ([REDACTED]) on a geographical base map in electronic form. Compensation was equal to [REDACTED]% of salaries, [REDACTED]% of direct expenses, and [REDACTED]% of outside services. The estimated Total Program Cost was \$ [REDACTED] to \$ [REDACTED] over a [REDACTED]-year period.

This project was one of the seven analyzed for [REDACTED] in [REDACTED], as part of the taxpayer's statistical sample for that year. The taxpayer has claimed labor costs incurred during [REDACTED], as qualified research expenditures for purposes of computing its research credit ([REDACTED]% of the labor incurred for this project in [REDACTED] was considered QRE's). These labor costs were incurred under Task Order No. [REDACTED].

8. [REDACTED], Project # [REDACTED]

This contract, dated [REDACTED], is a master agreement for [REDACTED] [REDACTED] was to perform the above services as described in task orders.

Compensation was to be based on time and an "[REDACTED]," not to exceed \$ [REDACTED]. [REDACTED] Contract \$ [REDACTED]. Amounts in excess of \$ [REDACTED] had to have prior written approval. Invoicing is monthly for each task order. [REDACTED] Contract \$ [REDACTED]. Disputed amounts "[REDACTED]" invoice. [REDACTED] Contract \$ [REDACTED]. The laws of [REDACTED] governed the agreement.

Section [REDACTED] states:

[REDACTED]

Section [REDACTED] provides that the taxpayer's plans, designs, specifications, procurement, and construction management services are to be prepared in accordance with the generally accepted, current, best practices of the industry. Section [REDACTED] states that [REDACTED]'s total obligation to redo or correct unsatisfactory work shall not exceed the greater of \$ [REDACTED] or [REDACTED]% of compensation for one year. Section [REDACTED] provides that construction work shall be free from defects in design, material or workmanship. It further states, "[REDACTED]"

Section [REDACTED] provides that all technical information developed by the taxpayer or its personnel shall be property of [REDACTED]. All inventions, discoveries, and the like belong to and shall be assigned to [REDACTED]. Id. Section [REDACTED], however, states that nothing in the agreement shall be construed to limit or deprive the taxpayer of "[REDACTED]"

[REDACTED] ."

Section [REDACTED] provides that the validity, interpretation and performance of the contract is to be governed and construed in accordance with [REDACTED] law.

[REDACTED] may for its convenience terminate the entire agreement or a Task Order at any time. In the event of a termination by [REDACTED], it shall complete any task orders outstanding. [REDACTED] shall compensate [REDACTED] for all parts of the work done, which has been earned at the time of termination. See [REDACTED] Contract, Sec. [REDACTED].

This project was one of [REDACTED] analyzed for [REDACTED] in [REDACTED], as part of the taxpayer's statistical sample for that year. The taxpayer claimed labor costs incurred during [REDACTED], as qualified research expenditures (QRE's) for purposes of computing its research credit ([REDACTED]% of the labor incurred for this project in [REDACTED] was considered QRE's).

9. [REDACTED] ([REDACTED]),
Project # [REDACTED]

[REDACTED] (" [REDACTED] ") is an [REDACTED] that was under contract ("Prime Agreement") with the [REDACTED] ("Client") [REDACTED]

[REDACTED]. The subject contract with [REDACTED] was entered into in [REDACTED], and was a subcontract between [REDACTED] and [REDACTED]. [REDACTED] was to provide [REDACTED]. Further design work on the [REDACTED] by [REDACTED] was contingent on the results of the [REDACTED].

This project was one of seven analyzed for [REDACTED] in [REDACTED], as part of the taxpayer's statistical sample for that year. The taxpayer claimed labor costs incurred during [REDACTED], as qualified research expenditures (QRE's) for purposes of computing its research credit ([REDACTED]% of the labor incurred for this project in [REDACTED] was considered QRE's).

Compensation for performing the ozone pilot study, per \$ [REDACTED] of the subcontract with [REDACTED], provided for a lump sum fee of \$ [REDACTED] for the basic services, as described in paragraph [REDACTED] and Exhibit [REDACTED] (this amount was amended to \$ [REDACTED] on [REDACTED]).

Additional services and/or compensation had to be mutually agreed to by both parties, and authorized by written amendment.

Paragraph provided that would provide the necessary facilities, personnel, materials, and equipment that are necessary or incident to perform all services described in Exhibit of the Subcontract, in a manner consistent with all applicable professional practices and standards.

Termination by was permitted if failed to perform. retained all rights to recover damages due to said failure to perform by. could also terminate for convenience on days' notice. However, in the event of a termination that was not the fault of, would be compensated for all authorized services performed to the date of termination. could not terminate.

Article of 's Prime Agreement provided that all plans, drawings, etc., are owned by the Owner (Client). This provision is incorporated into the subcontract from the Prime Agreement, by § of the subcontract. The laws of applied.

Tasks No. in Exhibit provide the detailed Scope of Services for, which includes develop a testing plan, and prepare for, conduct, and evaluate the pilot scale testing. Task No. of the Scope of Services for the subcontract provides that will prepare a final report including the following:

The subcontract between and provides that law governs it. Contract, Art. . The Prime Agreement is controlled by law. Agreement, Art. .

10. (""),
Project.#

The contract, dated, is for a plan update. was engaged to evaluate the system that were in use at the time. Mainly the team addressed the overflow problems with the current system's intake pipes and tanks. Also, they looked at improving

the quality of the treatment. The engineering team identified alternatives, evaluated them, and then selected a plan of action that was consistent with changes in governmental regulations. In the new plan, the existing treatment plant was used. The team identified improvements that could be made and implemented the improvements. A series of amendments functioned as work orders.

This contract provided that [REDACTED] would provide [REDACTED] for the improvements and tasks described in Attachment [REDACTED] (Scope of Services). These tasks included [REDACTED].

Amendment No. [REDACTED], approved on [REDACTED], authorized the [REDACTED] facility plan update work, with a budget of \$[REDACTED]. Compensation for these services was to be on a lump sum basis, as identified in Table [REDACTED] for each of the major tasks.

Payments were due [REDACTED] days from billing. [REDACTED] had the right to appeal or seek clarification of charges, but undisputed portions of billings were to be paid. [REDACTED] Contract § [REDACTED]. Work could be terminated by [REDACTED].

Section [REDACTED]. governs the level of competence applicable to [REDACTED]. This states:

[REDACTED]

This project was one of [REDACTED] analyzed for [REDACTED] in [REDACTED], as part of the taxpayer's statistical sample for that year. The taxpayer claimed labor costs incurred during [REDACTED], as qualified research expenditures (QRE's) for purposes of computing its research credit ([REDACTED]% of the labor incurred for this project in [REDACTED] was considered QRE's). These labor costs were incurred under Amendment No. [REDACTED], dated [REDACTED]. [REDACTED] law governs it.

ANALYSIS

I. The "Funding" Issue.

A. Legal Background.

1. The Regulations.

The credit under I.R.C. § 41 for increasing research activities is not allowable for "any research to the extent funded by grant, contract, or otherwise by another person or a government entity." I.R.C. § 41(d)(4)(H). The Code does not define the meaning of "funded."

The Regulations issued in 1989 interpret this provision as follows:

Research does not constitute qualified research to the extent it is funded by any grant, contract, or otherwise by another person (including any governmental entity). All agreements (not only research contracts) entered into between the taxpayer performing the research and other persons shall be considered in determining the extent to which the research is funded. Amounts payable under any agreement that are contingent on the success of the research and thus considered to be paid for the product or result of the research (see § 41-2(e)(2)) are not treated as funding. For special rules regarding funding between commonly controlled businesses, see § 1.41-8(e).

Treas. Reg. §1.41-5(d)(1).

The Regulation under I.R.C. § 41 also contains "mirror image" rules for determining when a taxpayer who pays for research by another person is entitled to claim the credit. Treas. Reg. § 1.41-2(e)(2). The contractual arrangement is the determining factor regarding who is entitled to the credit, for the taxpayer may claim the credit only if its agreement requires payment even if the research is unsuccessful. If, however, the taxpayer need not pay unless the research is successful, the client has "paid for the product or result rather than the performance of the research" and cannot claim the credit because it has assumed no risk. Id.

2. Judicial Interpretation.

This "funding" provision of the statute and regulation was interpreted by the Court of Appeals for the Federal Circuit in Fairchild Ind., Inc. v. United States, 71 F.3d 868 (Fed. Cir. 1995) rev'g 30 Fed. Cl. 839, 94-1 U.S.T.C. ¶ 50,164 (Ct. Fed. Cl. 1994). The taxpayer, Fairchild Industries, Inc., was a defense contractor for the Air Force. It entered into a fixed-price incentive contract to design and produce a new aircraft. The contract had two phases, a development phase and a production phase. In the design phase, the taxpayer was to develop and deliver a prototype aircraft and necessary support systems.

Under the contract, the Air Force was obligated to pay for research only if the taxpayer produced results that met the contract specifications in accordance with certain provisions of the Defense Acquisition Regulation ("DAR"). The taxpayer was entitled to payment only for work product delivered and accepted. If the work was deemed unacceptable, the Air Force could either reject it or require correction by the taxpayer at its own expense, or accept the work subject to equitable price reduction. 71 F.3d at 871.

The contract also provided that if the taxpayer made satisfactory progress, the Air Force would pay bimonthly refundable expenditures, denominated "progress payments." The taxpayer could not retain these progress payments unless the Air Force accepted the work to which they pertained was delivered and accepted by the Air Force. 71 F.3d at 871-72.

The taxpayer argued that none of the research was funded by the government because payment was contingent on success. The taxpayer urged that this question should be answered by looking to the "four corners" of the contract only. The taxpayer pointed to the contract terms that provided that progress payments could not be retained unless the work for which those progress payments was delivered and accepted by the Air Force.

The government argued that under government defense contracts and the parties' course of conduct, repayment of progress payments was generally not expected. The government argued that the test should be that research is funded where repayment is likely or expected in the normal course of events. Fairchild at 872.

The Court of Federal Claims agreed with the government, Fairchild Ind., Inc. v. United States, 30 Fed. Cl. 839, 94-1

U.S.T.C. ¶ 50,164 (1994). The Claims Court rejected the taxpayer's test and looked to both the contract and "how the parties actually conducted their transactions" 94-1 U.S.T.C. at 83,715. The Court also rejected the government's proposed "expected and likely" test. Id. The Court found that "at bottom" the research was conducted with the government's money and that it was the government that bore the risk, notwithstanding that the ultimate payment might be subject to equitable readjustment. Id.

The appellate court rejected the Claims Court's interpretation of the statute and regulation and essentially adopted the taxpayer's test. The Court reasoned as follows:

Treasury Regulation § 1.41-5(d)(1) provides that for the researcher to claim the credit, the amounts payable under the agreement must be contingent on success. The inquiry turns on who bears the research costs upon failure, not on whether the researcher is likely to succeed in performing the project. When payment is contingent on performance, such as the successful research and development of a new product or process, the researcher bears the risk of failure. Whatever risk Fairchild was bearing, the Air Force bore none of it, for the Air Force was liable for payment only when the work, line item by line item, succeeded and was accepted.

71 F3d at 873.

The Court further explained that the fact

[t]hat Fairchild received 'advances' or 'progress payments' during the course of performance did not alter the contract provision that Fairchild was not entitled to retain any such payments if it did not successfully produce the product to which the payment related. A progress payment does not commit the agency to accept unsuccessful performance

Id. at 873 (citations omitted).

B. [REDACTED]'s Position.

The position of the taxpayer is that all of the selected contracts are unfunded because [REDACTED] bears the ultimate risk of liability if [REDACTED] failed to perform. In other words, the taxpayer argues that [REDACTED] is liable for breach of contract if it fails to perform pursuant to the terms of its contracts. [REDACTED] derives this position from the general law of contracts, which is essentially derived from the common law. This position is described in the taxpayer's Response to ICR #12, [REDACTED].

According to the taxpayer, this liability does not need to be specifically described in its contracts because it is made a part of all contracts by the common law. As the Response states, "[REDACTED], " citing the Restatement (Second) of Contracts § 346. Response at [REDACTED]. The taxpayer views this liability as if it is an unwritten, implied term in all contracts. Response at [REDACTED].

The taxpayer then makes the point that in order to avoid this liability it must substantially perform in accordance with the contract by providing a product that is free from defects and is fit for the intended purpose. It cites several cases, including Newcomb v. Shaeffer, 279 P.2d 409 (Colo. 1955) for this. Newcomb states, "[t]he general rule is that a builder must substantially perform his contract according to its terms, and in the absence of contract governing the matter, he will be excused only by acts of God, impossibility of performance, or acts of the other party to the contract, preventing performance." Id. at 411.

The taxpayer maintains that its position is fully supported by the Fairchild case. Fairchild Ind., Inc. v. United States, 30 Fed. Cl. 839, 94-1 U.S.T.C. ¶ 50,164 (1994). Implicit in Fairchild is that the government's right to refuse to make a progress payment or recover progress payments previously made is that such rights are enforceable. Enforceability is implied in law, even if not stated in the contract. Similarly, with respect to [REDACTED]'s contracts, Enforceability is implied in law.

The taxpayer's position is further explained in a letter to the examining agent dated [REDACTED], regarding the "[REDACTED]" clauses found in many of the contracts. The response notes that the agent appeared to be concerned that the clause limited [REDACTED]'s duties under the contracts to something less than success.

The letter essentially reiterates the taxpayer's state contract law analysis described above. The letter cites additional cases for support.

C. The Examiner's Position.

The examiner believes that the taxpayer's application of general contract law to the funding issue is incorrect. The examining agent takes the position that, under the contracts, payment to [REDACTED] is not contingent on success. The agent adopts this position because the contracts lack provisions providing that payments are contingent on performance or that payments are recoupable by the client. The agent reasons that if the taxpayer's position is correct, no contract would ever be unfunded.

D. Service Position.

While the contracts contain differing provisions and contractual language, such as differing payment obligations, acceptance provisions, provisions regarding progress payments, and insurance provisions, [REDACTED]'s contracts may be grouped into two salient types. The first calls for the provision of [REDACTED]. The second type calls for a combination of [REDACTED]. All of the selected contracts call for design and consulting only, except for the contracts with [REDACTED] and [REDACTED]. [REDACTED] is a [REDACTED]. The [REDACTED] contract includes the delivery of a [REDACTED].

1. Contracts for Professional Services.

Our analysis is based on the majority rule in the United States that, in the case of professional services contracts, a professional, such as a design professional, does not guarantee the success of work or that designs or blueprints are perfect. As a leading treatise puts it, "An architect is not warrantor of its plans or specifications and is not liable for construction faults due to defects in plans if the plans were supported by the standard of common knowledge upon such matters at the time." James Acet, The Law of Architects & Engineers § 1.04 (3rd Ed. 1993) (hereinafter Acet; see also, Mathew Bender & Co., Inc., Construction Law 5A.01, 2002 LEXIS, Construction Law File (hereinafter Construction Law); Frischhertz Elec. Co. v. Housing Auth. of New Orleans, 534 So. 2d 1310, 1316 (La. App. 1988) ("In

the absence of an express contractual agreement to the contrary, an architect's obligation does not imply or guarantee a perfect plan."); City of Mounds View v. WaliJarvi, 263 N.W. 2d 420, 423-24 (Minn. 1978) ("the undertaking does not imply or warrant a satisfactory result"); Paxton v. Alameda County, 119 Cal. App. 2d 393, 259 P.2d 934 (1953); Lukowski v. Vectra Educ. Corp., 401 N.E. 2d 781 (Ind. App. 1980); Bayshore Dev. Co. v. Bonfoy, 75 Fla. 445, 78 So. 507 (1918).

Similarly, except in Alabama and South Carolina, an architect, engineer or other design professional does not impliedly warrant his designs or services, except to the extent that he is required to perform in a workmanlike manner. Acret at § 6.03. The rule is aptly stated in Auldlane Lumber & Builders Supply, Inc. v. D.E. Britt & Associates, 168 So. 2d 333 (Fla. 1964):

An engineer, or any other so called professional, does not 'warranty' his service or the tangible evidence of his skill to be 'merchantable' or 'fit for an intended use.' These are terms uniquely applicable to goods. Rather, in the preparation of design and specifications as the basis for construction, the engineer or architect 'warrants' that he will or has exercised his skill according to a certain standard of care, that he acted reasonably and without negligence.

See also Johnson-Voiland-Archuleta, Inc. v. Roark Associates, 572 P.2d 1220 (Colo. App. 1977) (refusing to imply warranty that drawings and specifications of professional engineers are fit for intended use); Surf Realty Corp. v. Standing, 78 S.E.2d 901, 907 (1953) ("[I]n the absence of a special agreement, [the professional] is not liable for fault ... resulting from defects in the plans because he does not imply or guarantee a perfect plan or a satisfactory result."); but see, Broyles v. Brown Eng'g Co., 151 So. 2d 767 (Ala. 1963) and Georgetown Steel Corp. v. Union Carbide Corp., 1993 U.S. App. LEXIS 23541 (5th Cir. 1993) (not officially published) rev'g 806 F. Supp. 74 (D.C. S.C. 1992) (applying South Carolina law).

The standard of care mentioned is the same as the standard of care as in a negligence action: That the professional exercises the care and competence of similar professionals at the time in the locality. Construction Law, 5A.01. This standard of care does not guarantee success.

With one exception, the cases cited by the taxpayer in its [REDACTED], letter do not address the issue of liability of design professionals for defective or erroneous plans or specifications. Progress Dev. Group v. Metro. Transit Auth., 1998 Tex. App. LEXIS 4603 (Tex. App. 1998), involved a contract between a paint contractor and a transit district to remove paint from a building. Austin v. Houston Power & Light Co., 844 S.W. 2d 773, 784 (1992), involved the breach of a contractual duty to manage a construction project. Montgomery Ward & Co. v. Scharrenbeck, 204 S.W.2d 508 (Tex. 1947) dealt with a contract to repair a water heater. Watson, Watson & Rutland/Architects, Inc. v. Montgomery County Bd. of Educ., 559 So. 2d 168 (Ala. 1990) concerned a contractual duty to supervise a general contractor. K-Lines, Inc. v. Roberts Motor Co., 541 P. 2d 1378 (Ore. 1975), dealt with a contract to manufacture and sell a truck. Finally, Greene v. Oliver Realty, Inc., 526 A. 2d 1192 (Pa. Super. 1987), involved the interpretation of a contract of employment to manage a building.

The case cited by taxpayer that holds that an engineer or architect impliedly warrants successful results is Broyles v. Brown Eng'g Co., 151 So. 2d 797 (Ala. 1963). As mentioned above, Alabama is one of two states that deviates from the general rule that a design professional does not impliedly warrant fitness or sufficiency for the intended purpose.

The [REDACTED] contract is governed by the law of [REDACTED]. In addition to consulting, [REDACTED] is to [REDACTED] for use by the [REDACTED], called "[REDACTED]."

As noted, the [REDACTED] contract contains a standard of care provision that provides that [REDACTED] shall exercise the degree of skill and diligence normally employed by professional engineers or consultants performing the same or similar services at the time. Any work done by the taxpayer to correct any services not meeting this standard will be performed at its own cost. [REDACTED] Contract § [REDACTED].

The "standard of care" provision in § [REDACTED] of the [REDACTED] contract seeks to limit the extent of [REDACTED]'s liability. These types of contractual provisions are known as exculpatory clauses. Generally, exculpatory clauses in contracts are disfavored but will be enforced where specifically bargained for between sophisticated parties of relatively equal bargaining power. See Tunkl v. Board of Regents, 60 Cal. 2d 92, 93, 383 P. 2d 441, 443 n. 6 (1963). Tunkl identifies six types of contracts in which exculpatory clauses are not enforced: Contracts in publicly

regulated businesses, contracts for medical care, emergency, or essential services, contracts offered to the public or a segment of the public generally, contracts of adhesion, contracts involving disparate bargaining power between the parties, contracts that do not permit adding protection or a waiver of the exculpatory clause for additional consideration; and contracts where the person or property is under the control of the vendor.

Alabama adopted the majority rule regarding exculpatory clauses in Lloyd v. Service Corp. of Ala., Inc., 453 So. 2d 735 (Ala. 1984) and Morgan v. South Cent. Bell Tel. Co., 466 So. 2d 107, 116-17 (Ala. 1985) (following Tunkl). Similarly, South Carolina, the other U.S. jurisdiction that implies a warranty of fitness in service contracts, also would enforce an exculpatory clause in certain circumstances.

Design professionals are regulated (in that they are licensed), the contract between [REDACTED] and [REDACTED] was the subject of bargaining, the parties were relatively equal in bargaining power, other engineering firms provide similar services that were available to [REDACTED], and the parties were knowledgeable business persons. Based on these factors, we conclude that the exculpatory clause in the [REDACTED] contract would have been enforced by an [REDACTED] court. Thus, notwithstanding the local law that a professional designer warrants his work for the intended purpose, § 6.1 of the contract would be enforced by an [REDACTED] court.

Thus, with respect to [REDACTED]'s contracts for the provision of professional services outside [REDACTED] and [REDACTED], including provision of plans, models, blueprints, or consulting services, [REDACTED] would not be held liable for breach of contract if it met the standard of care even if the design and consulting product did not perform successfully. We also believe that [REDACTED] and [REDACTED] would enforce contracts containing a "standard of care" clause similar to that found in many [REDACTED] contracts. However, with respect to the [REDACTED] contract, [REDACTED] would be held to a higher standard of success with respect to the [REDACTED]. Except with respect to the software system, [REDACTED] does not bear the risk of failure with respect to research under any of its design contracts. Consequently, except with respect to a portion of the [REDACTED] contract, its professional service contracts are funded within the meaning of Treas. Reg. §1.41-5(d)(1).

2. Contracts to Deliver a Finished Product: The [REDACTED] and [REDACTED] Contracts.

The [REDACTED] and [REDACTED] contracts differ from the other [REDACTED] contracts we have discussed in that [REDACTED]'s contractual obligations extend beyond providing design and consulting. Under these agreements, [REDACTED] contracted to provide a finished product.

a. The [REDACTED] Contract.

In the [REDACTED] contract, [REDACTED] acted as both the design professional and the general contractor for the project. In the construction industry, contracts that combine design and construction are called "design and build" contracts. See Construction Law at 5B.01[d]. In fact, the [REDACTED] contract is entitled "[REDACTED]" and [REDACTED] is referred to as the [REDACTED] in the contract. [REDACTED].

In the construction industry, contracts that combine design and construction are called "design and build" contracts. See Construction Law 5B.01[d], 2002 LEXIS, Construction Law File (hereinafter Construction Law).

A "design and build" contract involves a construction method in which one entity, known as the design-builder, assumes responsibility for both the design and construction phases of a contract. The party contracting with the owner may be a contractor who subcontracts for design with an outside design professional; an architect or engineer who subcontracts for construction, a joint venture between a design firm and a construction firm, or an entity which has the capability of performing both functions. Construction Law at 5B.01[d].

In the customary architect or engineer's contract, the design professional's responsibility for errors or omissions is limited to a breach of the standard of care. The builder's responsibility is to perform according to the designs and specifications provided. The two roles are blurred in the design-build contract.

The combination of roles presents an anomaly not addressed by traditional construction law standards. Construction Law, supra, at 3.09 [2] [b] [viii], describes this as follows:

In the traditional division of responsibilities, where the design is subject to the professional standard of care, the owner bears the risks associated with the design professional's non-negligent errors and omissions. When the design-build contractor controls both design and construction, it would stand to reason

that the contractor should assume the same responsibility that normally falls on the owner. In exchange for the privilege of being able to determine the design, the design-build contractor should be responsible to the owner for all of its errors and omissions, without regard to the question of negligence. It is clear that most design-build contractors do not want to assume such additional responsibility

Thus, in the absence of other enforceable contractual provisions, 's duty to perform would be to provide a facility described in the plans and specifications free from defects and faults that served its intended purpose. As we have seen, however, many contracts contain exculpatory clauses that will generally be enforced by state courts. Both the and contracts contain choice of law provisions. is governed by law (). would respect an exculpatory clause in the contract, since it followed the majority rule regarding exculpatory clauses. See Estey v. Mackenzie Eng'g, 324 Ore. 372, 927 P. 2d 86 (Ore. 1996).

Turning to the contract itself, several clauses in the contract may limit liability. The Preamble states that agrees to exercise the standard of care of "

." This provision resembles other standard of care clauses in contracts, except that it substitutes " for and it could be argued that this clause exculpates from having to guarantee success.

Other provisions of the contract are inconsistent with this reading. provides that shall be responsible for the acts and omissions of its employees and parties in privity with it. permit to rely on services and tests by surveyors, geotechnical engineers, and consultants hired by . provides that shall correct Work rejected by due to "

Due to these provisions in the contract, we believe that an court would interpret 's obligations under the contract as requiring substantial performance rather than merely exercising the due diligence of a competent designer-builder. Thus, we believe that the contract is unfunded within the meaning of the Regulation.

b. The [REDACTED] Contract

Work Order # [REDACTED] of the [REDACTED] contract calls for [REDACTED] to create a "[REDACTED]" software package known as "[REDACTED]" ([REDACTED]). Thus, the [REDACTED] contract calls for the provision of [REDACTED] in addition to consulting and planning activities.

The courts have reached disparate results in regard to whether the sale of computer software is a sale of goods or the sale of services. Compare RRX Ind., Inc. v. Lab-Con, Inc., 772 F.2d 543, 546 (9th Cir. 1985) (sale of goods, applying California law), Triangle Underwriters, Inc. v. Honeywell, Inc., 604 F.2d 737, 742-43 (2d Cir. 1979) (sale of goods -- software was incidental to sale of new mainframe computer), and Analysts, Int'l Corp. v. Recycled Paper Prods., Inc., 45 UCC Rep. Serv. 2d 747 (N.D. Ill.) (sale of goods) with Micro-Managers, Inc. v. Gregory, 434 N.W. 2d 97 (Wis. 1987) (specially created software not held to UCC standards) (1988); Data Processing Services v. L.H. Smith Oil Corp., 492 N.E. 2d 314 (Ind. App.), clarified on reh. 493 N.E. 2d 1272 (Ind. App. 1986) (custom software not a sale of goods), Liberty Fin. Management Corp. v. Beneficial Data Processing Corp., 670 S.W. 2d 40 (Mo. Ct. App. 1984)) (not a sale of goods subject to customary warranties), and Herbert Friedman & Associates, Inc. v. Lifetime Doors, Inc., 1986 U.S. Dist. Lexis 17237 (N.D. Ill. 1986) (whether goods or services predominate is a factual question).

The general test to determine whether a contract for software is a sale of goods, with attendant express and implied warranties, or is for services, with the attendant standard of care for a professional service provider, is whether goods or services predominate in the contract. Triangle Underwriters, Inc. at 742; Micro Managers, Inc., *supra*; Herbert Friedman & Associates, Inc., *supra*. The court will examine the intent of the parties, the contract as a whole, the type of services, and the relative significance of the services compared to hardware or computer equipment that is also provided. Even among the states applying the dominant aspect test, the courts could come to opposite conclusions depending on the jurisprudence of the state.

[REDACTED] would, however, be held to provide [REDACTED] a [REDACTED] that performed successfully, for two reasons. First, since [REDACTED] applies a blanket rule that contracts for professional services contain an implied warranty of fitness, an [REDACTED] court would not need to determine whether goods or

services predominated. Instead, a court in [REDACTED] would apply the state's blanket rule and hold that [REDACTED] was expected to deliver software free from substantial defects and fit for its intended purpose. Then, it would determine whether the standard of care clause was enforceable.

Secondly, Work Order # [REDACTED] requires the delivery of a [REDACTED]. An [REDACTED] court would likely view this as a specific warranty with regard to the [REDACTED] that would govern over the more general standard of care provision.

Thus, we believe that with respect to the [REDACTED] contract, [REDACTED] was required to perform by developing a successful software [REDACTED]. To the extent that the [REDACTED] contract also calls for other design and consulting product, however, the exculpatory standard-of-care provision would likely be enforced. Consequently, to the extent any qualified research is connected with the [REDACTED], we conclude that it is unfunded but that any potential research not connected with the [REDACTED] would be funded.

II. "Right to Use" Issue.

A. Legal Background.

1. Regulations.

Under the Regulations, research in which the taxpayer retains no substantial rights to use the research is deemed to be fully funded. Treas. Reg. § 1.41-5(d)(2). "Incidental benefits to the taxpayer from performance of the research (for example, increased experience in a field of research) do not constitute substantial rights in the research." *Id.* If the taxpayer retains substantial rights in the research under the agreement providing for the research, then the research is funded to the extent of payments and the fair market value of any property to which the taxpayer becomes entitled. Treas. Reg. § 1.41-5(d)(3). "A taxpayer does not retain substantial rights in the research if the taxpayer must pay for right to use the results of the research." *Id.*

2. Judicial Interpretation.

The "right to use" requirement was interpreted by the Court of Appeals for the Federal Circuit in Lockheed Martin Corp. v. United States, 210 F.3d 1366 (Fed. Cir. 2000) rev'g 42 Fed. Cl. 485 (1997) in the context of a federal defense contract. The

defense contracts in issue gave the government a nonexclusive right to use the research and a veto power over Lockheed Martin's right to transfer the research to third parties. The Court of Federal Claims found that Lockheed Martin's residual rights to use the research were "incidental benefits" rather than a "substantial right."

Reversing, the Federal Circuit found that the determination of whether a researcher retains substantial rights to use research "must be made by reference to the ... contracts alone." Id. at 1376. The Court then found that the agreements gave Lockheed Martin the right to use the research. Id. Further, it found this right to be substantial because "it permit[ted] Lockheed Martin to manufacture and sell up-to-date products meeting the needs of its clients." Id.

Finally, the Court rejected an argument based on the recoupment provisions in the contracts. These provisions provided that Lockheed Martin would reimburse the government for a share of research costs if Lockheed Martin sold to third parties. The court held that these provisions did not bear on Lockheed Martin's own right to use. The Court thought that these provisions differed from a royalty based on sales and did not "otherwise restrict the contractor's use of the items or technology." Id. at 1377.

3. Applicable Law: State vs. Federal.

The federal tax consequences of a transaction are determined by federal law. The property rights upon which federal tax consequences are based, however, are governed by state law. United States v. National Bank of Commerce, 472 U.S. 713, 722 (1985); Aquilino v. United States, 363 U.S. 509, 512-13 (1965). While these two cases involve tangible property, there is no distinction between tangible and intangible property rights for purposes of this federal/state law analysis. Cf. Drye v. United States, 528 U.S. 49, 53 (1999) ("right of inheritance" was a state property right to which federal tax lien could attach).

4. Design Professional's Intellectual Property Rights

The "right to use" the fruits of research is an element of intellectual or intangible property law. Generally, the intellectual or intangible property of a design professional, such as an architect or engineer, consists of two parts: (1) the actual blueprints, drawings, schematics, plans, and similar design product, and (2) the ideas, techniques, or know how utilized to create the design product (whether or not

incorporated in the design product). The design product may be copyrighted. The ideas, etc. may be patented or be protected as a trade secret.

Generally, a design professional is an independent contractor, and not an employee or agent of the client. See, e.g. Collins v. City of Decatur, 533 So. 2d 1127 (Ala. 1988). Consequently, absent a contractual provision to the contrary, design product produced for a project is an instrument of service owned by the design professional. Where, however, specific contractual provisions place ownership or the right to use design product in the owner or client, such provisions will govern.

B. Intellectual Property Terms in the Contracts.

Of the ten selected contracts, the [REDACTED] contract specifically reserves ownership of plans and drawings in [REDACTED]. The [REDACTED] contracts reserve ownership of these items (plans and drawings, etc.) in the client. The [REDACTED] contract is silent as to ownership of design and consulting product. However, the [REDACTED] contract reserves to [REDACTED] a non-exclusive royalty free license to any invention or developments derived from [REDACTED]'s proprietary information within ten years of the contract.

Two of the contracts touch upon the right to use non-copyright intangibles. The [REDACTED] contract also reserves to [REDACTED] all technical information, inventions and discoveries but that [REDACTED] retains the right to use "[REDACTED]" during its work for [REDACTED].

C. Conclusion

We conclude that, except for the [REDACTED] contract, [REDACTED] retained the right to use non-design and consulting product intangible property under the contracts. Furthermore, we believe that this right is "substantial" within the meaning of Treas. Reg. § 1.41-5(d)(2). Blue prints, drawings specifications and the like are developed for a single purpose and may not be reusable or may require substantial modification. Know-how and discoveries may be reused in taxpayer's business and incorporated in other design work for other clients.

The [REDACTED] contract presents a different picture. It vests ownership of all intellectual property developed under the

contract in [REDACTED] except for a limited residual right to "know how." The contract appears to reserve to [REDACTED] something akin to the benefit of its experience, an incidental benefit under Treas. Reg. § 1.41-5(d)(2). Consequently, except for the [REDACTED] contract, we believe that [REDACTED] retained the right to use the product of its research and that such right is substantial.

III. Business Component Issue

In order for research to be qualified for the research credit, I.R.C. § 41(d)(1)(B) requires that the activities be undertaken for the purpose of discovering information that is (i) technological in nature, and (ii) the application of which is intended to be useful in the development of a new or improved "business component" of the taxpayer.

Treas. Reg. § 1.41-4(b)(2) describes "business component" as a "product, process, computer software, technique, formula, or invention held for sale, lease, or license, or used by the taxpayer in a trade or business of the taxpayer."

Treas. Reg. § 1.174-2(a)(1) provides that qualified research "generally includes all ... costs incident to the development or improvement of a product." The term "product" includes "any pilot model, process, formula, invention, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license." Treas. Reg. § 1.174-2(a)(2).

The question is whether any qualified research of the taxpayer is used in a "business component" of the taxpayer. Except for the [REDACTED] and [REDACTED] contracts, [REDACTED] has contracted to provide consultative services for clients. [REDACTED] and [REDACTED], on the other hand, require the completion of a finished product, e.g., a [REDACTED], respectively.

Where the taxpayer provides consulting services, it provides advice for use in the client's trade or business, not its own. While it may be true that the taxpayer's trade or business is giving advice, section 41 requires that the "product, process," etc. be held for sale by the taxpayer or used by the taxpayer in its trade or business. This requirement is not met with respect to [REDACTED]'s contracts that involve design work or consulting services. Thus, we conclude that, in addition to our conclusions regarding funding, except for the [REDACTED] and [REDACTED] contracts, the requirements of section 41 are not met because of the lack of a business component.

CONCLUSION

As stated, we conclude that, in general, [REDACTED]'s contracts are not contingent on success where the standard of performance is that of a similar qualified design professional exercising due care. Where the contract requires substantial performance, warrants results, or the contract is governed by local law that applies a warranty of results standard, then the contract is contingent on results, and is therefore not funded. Also, it is our conclusion that, except where a contract has explicit provisions granting ownership of all intangible or intellectual property (not merely designs, specifications, blueprints and the like) to the client, [REDACTED] retains substantial rights. In the contracts we discussed, only the [REDACTED] contract contains such an ownership provision. Finally, we concluded that, except for the [REDACTED] and [REDACTED] contracts, any otherwise qualified research does not relate to a "business component" of the taxpayer's.

We hope that we have assisted you in regard to your questions. If you have any further questions, or require any further assistance, do not hesitate to contact us.

[REDACTED]
Special Litigation Assistant